CORPORATE COLLAPSE - Pitfalls for Directors, Auditors and Bankers

STEPHEN FRANKS

**Chapman Tripp Sheffield Young
Solicitors, Wellington**

INTRODUCTION

The greatest pitfalls are shared by directors, auditors and bankers alike - the pitfalls of foolish policy as a response to lots of corporate collapses happening together. I have listened with incredulity to some of the discussion at this conference.

We have heard proposals for more prescription of the negligence liabilities for auditors, directors and others for the alleged benefit of people who are already free to establish the preferred standard of care as they wish, just as they establish (or adopt) the other terms of their dealings. To their proponents these proposals need no more justification than slogans such as "fairness to the investors", "accountability for unacceptable conduct".

FAIRNESS

The "fairness" (equity) perspective of commercial law is deceptive. An example[1] may illustrate how that perspective could fiercely prohibit one of the most popular, and oldest forms of investment in our economy.

Is TAB betting on horses unfair? No - there are clear expectations about the risks people run and those they do not run. They do not accept the risk that the horses will be knobbled or stimulated to supernatural performance with drugs. The law will enforce the integrity represented by those expectations. But they do accept the risks of unequal information, chancy and grossly unequal outcomes, the statistical probability of a loss of capital, all in return for an opportunity to make windfall gains.

Fairness is a useful term to describe a set of desirable outcomes of a law. It conjures up an approach and a concern about the feelings of those involved in a matter that must be at the heart of any enduring system of law or government or management.

However, to try to use it as a prescription for commercial law is wrong. It is only a slogan. To talk of applying a fairness standard in commercial law is as ultimately meaningless as talking about a happiness standard or a niceness standard.

Fairness in commerce is a result of compliance with reasonable expectations. Reasonable expectations are in turn defined by the underlying economic realities and the express and implied agreements about risk allocation made by parties to transactions. Fairness thus reflects the agreement rather than the other way round. The terms offered in a transaction and the rules to enforce them create the expectation, and fairness is a consequence when they are observed.

In voluntary transactions people tend to be offered what they believe to be fair without any need for the law to stipulate what they must be offered. Commercial law should enforce bargains. It should not impose a judge's view of what those bargains ought to be. Where terms are not expressly considered by the parties the judicial function should be to imply what they probably would have agreed if they had talked about it - the traditional contract formulation.

Well meant but misconceived attempts to rewrite the rules to impose universal mandatory standards of care on company management comprise the main assaults on limited liability. They would dictate what people may, and may not, agree upon, whether or not they want that so called protection. Flanking attacks use:

1. Newly asserted fiduciary duties of company officers (and perhaps those who appoint them as advocated by Thomas J) to those with whom they deal (***Lion Breweries Ltd v Scarrott & Ors*** (1987) 3 NZCLC 100,042);

2. Strict liabilities under consumer protection legislation such as the Fair Trading Act and securities market regulation, both overreaching the carefully evolved balances of company and contract law; and

3. Erosion of the contract basis of commercial relationships by direct insinuation of tort principles (***Centrepac Partnership v Foreign Currency Consultants Ltd & Ors*** (1989) 4 NZCLC 64,904, ***Rowlands & Ors v Collow & Anor*** 18/4/91 CP 373/87 Wellington - Thomas J).

I believe all will damage and perhaps destroy the value of limited liability.

BETTER ENFORCEMENT

I should first make it very clear that I fully support clarification and better enforcement of legal liabilities for dishonesty. I urge the improvement of remedies for those who suffer loss from self interested dealings by directors and others in breach of their duties of loyalty and good faith, and for lies by those who owe a duty of truthful disclosure. If they are not, other reforms, whether well conceived or misconceived, will be in vain.

ROLE OF NEGLIGENCE LIABILITY

Negligence liability is advocated without any discussion of its economic role (or indeed of limited liability).[2] It reflects a serious political and legal ignorance of the nature of risk, and ignorance of the means by which contract law, company law and normal commercial incentives and sanctions are aligned to allocate risk. In the absence of economic analysis, our fumbling in these areas has no more validity than did the mediaeval churches and Islamic scholars' attempts to avoid recognising the economic realities of a time value for money - namely interest, and the feeling that interest is usury - inherently unfair.

What is the public policy to be served by negligence liability? Do judges and regulators and legislators really believe they can regulate loss allocation to reduce business losses and improve profits, better than the loss allocations people agree among themselves tailored for each situation?

By way of example I will examine recent judicial struggles with "reckless" and fraudulent trading in s319 of our existing Companies Act, for disturbing clues as to how they might cope with the proposed expansion of negligence liability.

HOW WILL THE COURTS ASSESS NEGLIGENCE?

The New Zealand courts have been struggling for some years with the development of a standard to apply in relation to s319(1)(b) of the Companies Act which imposes liability for reckless trading. The test formulated by Bisson J in ***Thompson v Innes & Ors*** ((1985) 2 NZCLC 99,463) is:

> "Was there something in the financial position of this company which would have drawn the attention of an ordinary prudent director to the real possibility, not so slight as to be a negligible risk, that his continuing to carry on the business of the company would cause the kind of serious loss to the creditors of the company which s320(1)(b) was intended to prevent".

He held that reckless meant more than mere inadvertence or mere carelessness but it did not involve blameworthy behaviour to the extent of dishonesty. That test has been expressly adopted in a number of subsequent cases (***Re: Bennett Keane & White Ltd (in liq) (No 2)*** (1988) 4 NZCLC 64,318, Eichelbaum J; ***Re: Petherick Fashions Ltd (in liq)*** (1987) 3 NZCLC 99,946, Eichelbaum J; ***Re: Rex Wood Service Centre (in liq)*** (1987) 3 NZCLC 100,199, Doogue J).

I acknowledge that the courts have not volunteered to determine this issue. The legislation requires them to establish a test which does not involve moral blameworthiness, because other provisions in that section and in s321 do address fraud and dishonesty.

Still, there is a distressing lack of appreciation of fundamental role of risk and return in commerce in all the judgments in the area.

Bennett Keane & White involved a hotel and restaurant business. I understand that for restaurant businesses, approximately 1 out of 3 survive after 2 years. On objective probabilities it is therefore very hard to see how the directors of a restaurant company could ever fail to be alive to the "real possibility, not so slight as to be a negligible risk, that their business could fail". Much of the capital in a restaurant business will be tied up in its fit-out. The realisable value of a failed restaurant is normally a fraction of its cost price. Restaurants that succeed do extremely well, those that fail will almost invariably cause loss to their creditors unless they are financed with a high proportion of equity.

Should not the creditors of a restaurant business be expected to take that into account? Perhaps they do. Perhaps there is an expected loss ratio built into the pricing of their supplies or the interest rate charged on advances or profit margin on the fit-out work. Presumably prudent trade suppliers to restaurants keep the outstanding credit to low levels.

People dealing with the restaurant business will also be aware of the eternal optimism of the initial owners. I understand one of the present members of the Court of Appeal has been heard to respond to a jibe about a hotel business he had been associated with, that everyone knew that only the fifth owner of a hotel ever kept his money. Is it not realistic to expect that creditors of a business will take into account such possibilities? They know directors' judgment can be wrong, that they may be foolish.

The point of this examination is that people contracting with a business do share in the risks of the business. They will, if they have asked about capitalisation, assume that the shareholders' capital goes first, they may seek personal guarantees or other assurance, they may insist upon progress payments and their profit margins may reflect the risk.

It concerns me that in none of the cases I have read is there any indication that the judges thought these were relevant enquiries. There has been no obvious appreciation of the fact that a risk of failure is not the end of the matter in determining recklessness (let alone negligence). In virtually all business decisions it has two elements. One is the failure risk. The other is the expected level of return. A very high risk of failure may be more than offset by a commensurately high anticipated return. Consider, for example, the 95% loss risk for a company set up expressly to drill a number of oil search wells. There is no reason why the courts should be anxious to intervene to impose personal liability simply because business continues to be conducted when there is a high risk of failure.

This may be distinguished from the question when shareholder funds have been demonstrably exhausted.

In short, these matters should not be addressed by the courts at all. They involve an ***ex post*** attempt to reallocate risks which the parties have already either explicitly or implicitly agreed upon the pattern of loss sharing.

Each time the courts retrospectively alter that, they act unfairly. The unfairness is in upsetting what can be the only reasonable expectations, namely those which would be ascribed to the parties, if they had turned their minds to it, and asked the questions in advance.

If we have a law which allows that ***ex post*** alteration, that too will become part of the pattern of expectation. However, no one should delude themselves. Contractual uncertainty of that nature has its own high and unavoidable costs. There are no "free lunches" in law.

SLOGANS

The reformers have the very best of intentions and, like the communists, they have the best songs. Their slogans have an irresistible appeal both within and outside the ranks of lawyers. Words like "accountability" can be used as a kind of flaming cross, a neon version of an older, more neutral word "liability". It used to have specific meaning indicating an organisational structure in which each manager has clear lines of reporting and there are clear means of measuring the manager's performance matched by clear delegation of powers to perform. It did not mean liability. This mutation into liability must leave those who used it originally searching for a new word.

Another phrase never far from the pen of the reformers is "abuse of the privilege of limited liability". Why is a standard implied term of a contract, flagged in every dealing by the word "limited" treated as a privilege? That attitude betrays underlying hostility to a contract, and the freedoms it promotes.[3]

In 1854, Baron Bramwell was one of the two person minority in favour of limited liability companies on the eight person commission which reported to the United Kingdom parliament (immediately before the government rejected the majority view against limited liability and enacted the first limited liability company statute). He saw it instead as removing a restraint which unfairly prevented partnerships from availing themselves of the limited liability otherwise available on contractual terms.

Those who don't wish to think through the issues try to claim the high moral ground. They argue "Why shouldn't we use a change in the law to avoid future losses of the kind suffered in the collapse?[4] People who oppose higher standards must want to protect the careless, the incompetent and the unscrupulous. Their reasons can only be darkly guessed at. The law must both reflect, and be co-extensive with, proper ethical principles."

I believe such thinking is reactionary and simplistic. What is the economic role of negligence liability? The reformers seem to see no need to analyse this.[5]

LOSS SHIFTING

Negligence liability shifts losses. It shifts them from where they fall initially to some other party who is ordered to carry them because that other party is thought:

1. better able to bear the loss;
2. better able to spread the costs of it across the activity that inevitably gives rise to the loss;
3. better able to have contracted to bear the loss by implied or expressed terms as to responsibility, or by way of insurance;
4. to be in the best position to ensure that the risks of such losses are minimised;
5. to need that sanction or disincentive to prevent careless conduct.

Why should we want to shift losses from particular investors and lenders? Their role is, ***prima facie***, to bear those risks, unless they have contracted with someone else to bear them. It can only be the last objective (minimising risks of negligence) that is served by imposing non-contractual liabilities on directors. But is minimising risk our primary economic objective? There is no doubt that risks of fraud or other dishonest conduct must be minimised. But the costs of discouraging errors of judgment or carelessness by shifting loss may be very high indeed, particularly where the community wants people to be innovative, to experiment, to take risks, to hazard their capital. Limited liability is established to encourage people to take the risk of loss.

I predict that in a year or two the fashionable complaint bandwagon will not be about the absence of law reform and effective constraints on careless directors, but instead it may be "how do we get New Zealanders to take business risks, to try new things, where can we get venture capital?". The experience of the last decade has perhaps produced a business community as unhappily risk averse as they were unhappily foolhardy during the boom.

CONSEQUENCES OF LOSS SHIFTING TO DIRECTORS

The limited liability structure recognised that business losses were inevitable. All who dealt with a limited liability company agree in advance that they bear their own losses to the extent they exceed the resources within a company, and in a pre-agreed order.

Plainly, when shareholding is separated from management, the management, as agents of the controllers should no more guarantee performance of the company's obligations than do the shareholders. Any other arrangement makes the limitation of liability idle.

Limited liability is at least as vital for directors, as the agents of the shareholders, as it is for the shareholders themselves. Agents cannot be expected to enter into transactions with business risk of a scale far beyond anything they could enter on the basis of their personal assets, yet accept the possibility of full recourse to all their personal assets if the risk proves to be assumed unwisely, if, as directors, they share in a tiny portion, if any, of the returns if those risky transactions turn out to be profitable. They may:

1. refuse to make risky decisions, in which case the purpose of the shareholders in putting up risk capital may be frustrated because their agents are more risk averse than the shareholders;

2. they may demand a full recompense for the risk. In theory that recompense would be the major portion of the risk return that should otherwise go to the shareholders;

3. they may demand insurance or indemnity arrangements. Insurance will either not be available or it will cost the same amount as the risk return mentioned above. An indemnity from the shareholder will eliminate the benefits of limited liability to the investor.

It is possible that imposing liability may reduce the incidence of negligence to the overall benefit of commerce. It is at least equally possible that the lottery element of negligence actions with their inevitable harsh hindsight judgment may produce a risk aversion in directors which could be a greater loss to commerce than existing costs of negligence.[6]

KINDS OF DIRECTORS

We have to think about the kinds of directors we are concerned with. Perhaps the kinds of directors we most want, those with a background and position that means they have most to lose in a negligence action, will be most inhibited. Those most likely to be negligent could be least deterred, having little to lose.

EXISTING INCENTIVES

To align the interests of all stake holders in a company, shareholders take last and take any surplus after contractual claims are met. It is very similar to the mechanism any mother of a large family uses to ensure a cake is divided without argument. One child is given absolute discretion to cut the cake without interference, provided that child takes the last piece. We do not need to say to the divider "if you make a mistake and leave nothing for yourself, and perhaps a smaller than expected share for the last person to choose before you, you will have to compensate the losses". The incentives are already aligned correctly and all the threat does is decrease the likelihood that the divider will accept the role of divider.

In most companies the directors are also shareholders. If they are negligent, as residual claimants they inevitably damage their own interests before those of other non-equity stake holders. Personal guarantees often avoid limited liability by specific contract. Directors therefore commonly have some of their own assets at stake and nearly always have their reputations at stake.

The law already provides for the duty to shift and the authorities of directors to be terminated when there ceases to be any shareholders' money at stake (on insolvency). What then is expected of the additional liability proposed? Is it intended to compensate for loss?

INSURANCE COMPULSORY?

If compensation or loss spreading is an objective it won't be achieved unless insurance is compulsory, not merely permitted (instead of being prohibited or discouraged as at present). Insurance spreads losses. Is it self evident that our economy is improved by lifting losses from those who have agreed to bear the risks, who can take them into account when determining what risk return they require, and to guard against them by their selection of agents (directors) and spreading it across the entire community through insurance? Liability attribution as a loss spreading exercise is extremely expensive.

If it does not deter unnecessary loss making and does deter useful risk taking, the process is a net dead cost to the community. Even if it does achieve some of those objectives, it is a very expensive process. Lawyers, witnesses, judges and others shifting around losses which crystallised years, even decades, ago seems to me to have social benefit only where it is necessary in pursuit of dishonesty or breach of contractual duties.

Attribution of liability may have very important and unintended effects on the management structures obtained. For example:

1. **Governing v Managing Board:** A governing board may see its function as being to judge the performance of the executives against pre-agreed performance criteria, to sack them when necessary and to appoint new ones. They are monitors on behalf of the shareholders, and not managers. Directors negligence liability militates strongly against this efficient and desirable model.

2. **Committees:** Committees are not efficient decision makers. Collective liability virtually compels collective decision making by management.

3. **The Composite Board:** The standard of a reasonable director imperils the single talented member of a composite board. For example, a shop floor representative with practical experience may be essential amongst a board comprised of lawyers, accountants and other managers, yet that member would be at peril if some level of understanding of financial statements and legal requirements is part of the job description of the reasonable director.

4. **Non-Executives at Risk:** The hazards of executive dominated boards are recognised, but a possible negligence liability is strong discouragement to any non-executive director. If the company is not of a size which can afford sophisticated reporting requirements to generate the necessary defensive paper trail of minutes and reports, any non-executive director relying primarily on experience, intuition and knowledge of people will be disadvantaged in court proceedings.

5. **Self Serving Evidence of Due Procedure:** The self serving records of steps that appeal to courts (unduly influenced by administrative law approaches to decision making) include:

   (a) addiction to written reports;

   (b) self serving minutes of prolonged discussions in questioning;

   (c) the use of outside advisers;

   (d) deferral of decisions.

   This energy might be more productively used in increasing the number of decisions by wise use of intuitive judgment instead of the cynical pseudo-objective establishment of rationality of decisions.

6. **Pursuit of Advisers:** The consequence of increased use of outsider advice will be further investigation by the courts, in turn, of the soundness or wisdom of those reports. A liability trail may increasingly pursue all the various advisers and the board may wish to rely in addition to the auditors who are presently in the front line.

It is far from obvious to me that the encouragement of these procedures has much to commend it economically or morally. I see as far better the simple conception that a contractual allocation of risk freely entered by parties to a commercial transaction should be the beginning and the end of a question, in the absence of fraud or dishonesty.

Lawyers have intuitively recognised and expressed some concern about one obvious evidence of cost, namely the disinclination of professionals to become directors, without recognising that it is but the tip of the uncertainty iceberg created by the regulatory dogooders.

DDT

An environmental analogy is not unfair. Legislated duties of care are like DDT. They may appear effective against corporate grass grubs and financial mosquitoes. The public are grateful. They applaud the providers of DDT. If some is good more is better. Eventually someone notices that there are fewer highflying birds around, the worms have died and the ground is becoming less productive, as the natural cycle of decay and fertility is disrupted.

Very late, we may recognise that the chemical swarms of accountants and lawyers and regulators needed to keep our system in balance may have something to do with the injudicious use of regulatory DDT, instead ensuring the environment is friendly to reliance on of voluntary contractual blackbirds.

The true role for regulators, if there is one, is the boring, diligent emptying out of the fraud swamp to deny cover to mosquitoes. They should not be encouraged happily to spread DDT on the good, bad and indifferent alike.

FOOTNOTES

1. Discussion Example: What should the law do about people who propose to sell in New Zealand financial products described as investments, with the following characteristics?

   (a) The average overall return year after year can be shown to be a loss of between 20% and 30% (though some individual investors do get sporadic and very substantial dividends). That negative return is a result of taxes and amounts skimmed off by insiders.

   (b) The insiders use the amounts skimmed off to subsidise their personal businesses, producing things which the industry must use.

   (c) The officially required disclosure to investors is rudimentary. More detailed information is provided by a network of analysts and journalists who process insider tips, speculation and rumour into published recommendations. There is no supervision of the sources of information or of the quality of recommendations or the conflicts of interests or connections of those who publish them.

   (d) Investments are heavily marketed to lower socio-economic groups. Some lose their life savings. Others use money their families can ill afford and sometimes lose their entire investment.

   (e) Rich and well known people are appointed to the boards of the organisations that offer the investment opportunities add glamour and enticement to the industry notwithstanding the heavy losses it can cause.

   (f) There are no legal cooling off periods for investment, or refunds made even if investors have been misled by insiders' careless statements of their expectations as to performance.

   (g) The relative risks of each investment can be changed arbitrarily after an investor has subscribed. Insiders dilute the returns to early subscribers by subscribing for securities without disclosure.

2. What is the risk to the economy if limited liability is effectively abolished? Maybe it is a bad idea, a "privilege" that should be readily withdrawn. These are perfectly arguable points (though they have not been argued). It may be that we do not really need to offer limited liability to the inexperienced or the unsophisticated or those without accounting or financial skills or those whose circumstances preclude hiring legal or valuation or merchant banking or tax or other experts to appraise business proposals.

   Perhaps we would have a more efficient economy if people's savings had to be filtered through institutions which satisfy the proposed pre-qualifications for entitlement to limited liability; that is, management by people who can demonstrate skill and experience as evaluators of business proposals, credit risk and financial statements.

Are not bankers the most clearly qualified? I think it will take a few more years yet before we forget that bankers, many of them regarded as the leaders in their field (DFC) lost money as eagerly as many of our amateur directors, and in bigger lumps.

3. If we think back to some other legal slogans that seemed self-evident to a previous generation we should become very careful indeed. In New Zealand we had 40 years of legislative prohibition of "wasteful and unfair competition". To prohibit it seemed self-evidently sensible. Yet, in the transport field for example, that licensing regime destroyed coastal shipping and led New Zealand Rail into a position where it has drained billions of dollars from our economy.

4. Negligence liability proponents see tort as an obvious solution to commercial irresponsibility, to ensure that management employ greater skill, diligence and care by making them liable if they don't show it. It is foreseeable that if management aren't careful, diligent and skillful others whose interests they affect (shareholders, creditors and employees) will be harmed. Most of those others must necessarily rely on the management, it is a relationship of trust. That gives sufficient proximity. To proponents it would seem only fair that those harmed should be compensated by those who have caused the harm.

5. It is ironical that regulators, who require of new issue promotes full disclosure of all assumptions and costs and risks, irrespective of the cost and delay of ensuring such disclosure, do not apply the same prior disclosure requirements to publication of their own regulatory proposals. They are often advanced as justified by the virtue of their objectives without being thought to need a detailed calculation of the cost, benefits and (most importantly) the assumptions.

6. The alleged ***need*** to impose a negligence standard is a warning that it may be unwise. If the veil should be pierced and the negligence standard tightened, why have the parties not chosen to do so themselves? They have been free to. Many other vital features of the investor/manager/ agency relationship are carefully defined. Debentures may stipulate all kinds of operational constraints. Articles may specify responsibilities and required standards of performance and rights and detailed procedures for resolving disputes. Terms of appoint frequently do specify a standard of performance. Stock Exchanges may stipulate in great detail certain management/investor relationship arrangements for various categories of listed issuer. No universal voluntary arrangement would stipulate a mandatory, enforceable duty of care for company management which would enable disappointed parties dealing with the company to recover from management a broad range of losses arising when the risks mature. They are seen as inherent in conducting business.